

4. THE SALEM RECOVERY

- 4.1 The first NSN report also dealt with what is termed the Salem recovery. The background to the recovery is as follows: In December 1979 an oil tanker, the Salem, discharged a cargo of crude oil in Durban. SFF was deceived into purchasing a quantity of crude oil which had formed part of this cargo. After having paid for and received the oil, Shell International Petroleum Company Limited informed SFF that they were the true owners of the crude oil. To settle the dispute SFF and Shell entered into a written agreement. In terms of clause 6 of this written settlement, the parties agreed to share the proceeds of any financial recovery made by either party from an outside party.
- 4.2 Shell was able to recover a certain amount from the perpetrators of the deception. Pursuant to the settlement agreement SFF was entitled, and indeed received, payment of R6 784 754,33 of the monies received by Shell. The receipt of these monies was reflected in the SFF books of account as "Saldanha Strategic Sales" and was included in the 1993/94 audited financial statements of SFF as such.
- 4.3 The Salem recovery probably drew the attention of NSN because of a hand written note that Mr Van Zyl sent to Mr Pithey. The note was headed "Salem" and read as follows:

"We (Shell and myself) had agreed on the following:

- 1. They will write you a letter explaining the matter. This letter will be hand delivered.*
- 2. We then advise them what to do with the money. In view of transparency we must find a way which will not disclose the origin of the money.*

3. *We again agreed on secrecy, no one will disclose anything.*
4. *If you agree, we can inform Minister Botha. He can then thank (or whatever) John Drake over the telephone, nothing in writing. In doing it this way Shell gets acknowledgment from the top that we have the money but we don't disclose the origin in the books".*

4.4 Mr Pithey later explained to Mr Petersen from NSN that the idea was not to make full disclosure so as not to embarrass Shell, but nevertheless to make sure that SFF gets the money that is due to them. He averred at the time that Shell was anxious to avoid the issue becoming a matter of public debate because of the Salem history. In their report NSN criticises Mr Van Zyl for this letter. Subsequently Mr Van Zyl was charged in a disciplinary hearing for conspiring to falsify company documents by suggesting or advising that entries in the financial statements of the company should be made to disguise the source of the income. He was found guilty. In view of the mentioned disciplinary charge, I did not deal with Mr Van Zyl's actions further in this regard.

4.5 The NSN report furthermore, correctly so, made the point that the recovery was incorrectly recorded. It seems that the Directors were informed of the recovery, but Mr Pithey stated that no detail of the accounting treatment of the monies was known to him, or to the best of his knowledge, to any of the other Directors at the time. I do not believe that the mis-categorisation of this amount affects the overall fair presentation of the financial statements, since there is no effect on the nett income figures. The money was recorded as received, even though it was done incorrectly. It should furthermore be noted that Price Waterhouse did not audit this amount as it was not included in the audit sample. It was immaterial to the financial statements and therefore there

would have been no particular reason for the amount to have been audited.

- 4.6 Whilst the amount of R6 784 754,33 may not have been picked up in the context of the SFF audit, its incorrect posting ought to be deprecated as inappropriate. Even though it did not have any practical negative consequences it ought not to have been done and reflects a practice that should not be repeated in the future.
- 4.7 As stated above management was held accountable for allowing incorrect procedures to take place and I am satisfied that disciplinary steps were implemented.

5. CHANGE IN ACCOUNTING POLICY (R170 MILLION ISSUE)

BACKGROUND

- 5.1 During the three financial years 1990/1 to 1992/93 strategic oil was sold out of the Ogies mine (where SFF stored oil) and replaced in the Saldanha depot of SFF. The Saldanha depot was a preferable location to hold oil, as oil could be more easily accessed from Saldanha (being at the coast) than from Ogies. This oil was sold and replaced rather than physically moved as it was considered more cost effective. Most of the oil was sold during the financial years 1990/1 and 1991/2 and replaced in financial years 1991/2 and 1992/3. The strategic oil was valued at its historical cost of acquisition, which was very low compared with the ruling market prices. As such, significant profits were realised on the sale of the oil, which were then utilised to repurchase the oil. This resulted in large profits being shown in the financial statements and the value of the new stock purchased being substantially higher than the old value.
- 5.2 In 1992/3, when the replenishment of stock had been completed, Management became concerned about the large profits being shown and the increase in the value of the stock when the volume had remained relatively constant, that were shown in the 1992/3 financial statements. This only became apparent to them in 1992/3 when the major portion of the stock was replaced.
- 5.3 The 1992/3 financial statements were finalised including a note explaining the increase in strategic stock and were signed by Mr Vorster (Chairman) and Mr Hefer (Chairman of the Board Audit Committee) on 2 September 1993. Price Waterhouse issued an unqualified audit opinion on the financial statements on the same date. On 21 September 1993,

Mr Vorster signed a resolution stating he had held an Annual General Meeting of the members of SFF and that the financial statements were approved.

5.4 The finalisation of the CEF group financial statements (which incorporates the SFF financial statements) were delayed due to problems at MOSSGAS. Management took this opportunity to withdraw the original 1992/3 financial statements and to change the accounting policy to reflect what they felt was the substance of the transaction, namely that the stock had not been sold and then repurchased, but that the stock had been moved from Ogies to Saldanha. The profits relating to the sales were reversed and the value of the oil repurchased reduced by those profits less the estimated cost of the transshipment of the oil if it had been moved.

5.5 The new accounting policy stated:

“When strategic crude is sold from one tankfarm and replaced in another tankfarm the original cost price plus any transshipment cost is used to value the stock at the new tankfarm.”

5.6 The effect of this new policy was that the value of the new stock purchased for Saldanha, to replace amounts sold from Ogies, was written down to the original cost of the stock sold at Ogies. All profits made when selling stock out of the Ogies depot were then set off against the amounts written off on the replacement of that stock at Saldanha.

5.7 Over the three years the same quantities of oil, approximately 30 million barrels, were sold and replaced.

EXPLANATION OF THE ACCOUNTING POLICY CHANGE

- 5.8 The accounting policy change is complex. In essence the new policy allows the company to sell strategic oil from one location and purchase oil in another rather than transferring the oil physically between depots. The sale and repurchase are effectively ignored and the oil is kept at the original cost price. This means that the profit on the sale offsets the cost of the replacement oil.
- 5.9 Below I have put a very simple example that has assisted me in understanding the concept of the new accounting policy. This example is not intended to be a full representation of the accounting policy, but to facilitate an understanding of the broader concept.
- 5.10 It is assumed that a barrel of oil originally cost R5 and it was sold for R20 from location 1. At the same time a barrel of oil in location 2 was purchased for R20 (the purchase and sale price would be the same as the oil was purchased/sold at the same time). The effect would be as follows:

<u>Sale</u>	<u>R</u>	<u>Purchase</u>	<u>R</u>
Sale proceeds	20	Purchase price	20
Original cost	<u>5</u>	Original cost	<u>5</u>
Profit	15	Writedown required to reduce	15
		<i>purchase price to original cost</i>	

- 5.11 The profit on the sale of R15 offsets the writedown on the newly purchased stock of R15 so that there is no effect on the financial statements and the stock is still valued at R5.
- 5.12 The policy requires that any stock that is sold be replaced eg the quantities sold and purchased must be the same.

- 5.13 The SFF however did not buy and sell the same amount of stock in the same year, but did so over the 3 years financial years 1990/1 - 1992/3 inclusive. As the stock was bought and sold at different times the sale and purchase price was not always the same. Over the 3 years the stock purchased cost more than the stock sold so that there was an overall loss/cost on the transaction of approximately R46 million (ie the repurchased stock cost R46 million more than the stock sold).
- 5.14 The new accounting policy did not require that the quantities of oil sold and repurchased be matched in the same year. Taking the example above, if it is assumed that 2 barrels were sold in year 1, but only 1 was replaced in year 1 and 1 in year 2, with all the other information being the same. In the first year a profit of R15 would be shown in the financial statements (eg R30 profit on the sale of two barrels less R15 for the writedown to cost of one barrel) and in the second year a loss of R15 would be shown (eg the writedown to cost of R15, but with no offsetting profit).

FINANCIAL EFFECT OF THE CHANGE IN ACCOUNTING POLICY

- 5.15 The sale and repurchase of the strategic stock occurred over three years and had been accounted for under the old accounting policy in those three years. Therefore when the accounting policy was changed each of those years had to be adjusted to account for the transaction under the new accounting policy. The effects of this change in policy were:

	1991	1992	1993
Effect on Sales	(245 461 775)	(982 537 621)	(368 359 007)
Opening Stock		19 520 327	98 301 699
Effect on purchases	147 981 010	147 805 894	1 346 692 025
Closing Stock	(19 520 327)	(98 301 699)	(969 803 950)
Effect on Trading profit	<u>(117 001 092)</u>	<u>(913 513 099)</u>	<u>106 830 767</u>
Result of stock transfers	9 325 044	114 647 899	(170 093 469)
Net effect on net income	<u><u>(107 676 048)</u></u>	<u><u>(798 865 200)</u></u>	<u><u>(63 262 702)</u></u>

5.16 In the revised 1992/1993 financial statements in which the accounting policy was changed the figures above were shown as follows:

- 1991 changes were shown as a prior year adjustment to Reserves of R 107 676 048.
- 1992 changes were shown by changing the comparative figures.
- 1993 amounts were taken into account when disclosing the figures in the revised financial statements.

5.17 The amounts of strategic stocks sold were not fully replenished in the same year resulting in greater profits being shown in the income statements in 1991 and 1992 due to the lower value of the stock. Contrary to this when stocks were replenished in 1993 for sales made in prior years greater losses were shown as seen in the table below:

	1990/1991	1991/1992	1992/1993	TOTAL
Saldanha purchases adjustment	(131 456 100)	(128 877 068)	(1 151 786 094)	(1 412 119 262)
Profit on Ogies sales	219 611 821	848 960 896	343 546 545	1 412 119 262
Deferred profit	88 155 721	720 083 828	(808 239 549)	0
Ogies sales reversed	245 461 775	982 537 621	368 359 007	1 596 358 403
Saldanha purchases reversed	(147 981 010)	(147 805 894)	(1 346 692 025)	(1 642 478 929)
Nett effect	97 480 765	834 731 727	(978 333 018)	(46 120 526)
Result of stock transfers	9 325 044	114 647 899	(170 093 469)	(46 120 526)

5.18 The nett effect of R 46 120 526 represents the higher price paid for crude oil purchased in Saldanha than the selling price obtained from stock sold out of Ogies over the three years.

5.19 The amount is reconciled as follows:

	Barrels	Avg Price per barrel	Rand
Value of Saldanha purchases	30 714 025	53.48	1 642 478 929
Value of Ogies sales	30 714 025	51.97	1 596 358 403
		<u>1.50</u>	<u>46 120 526</u>

5.20 Mr Cilliers and Mr Van Zyl made a submission to the Board Audit Committee on 28 October 1993 on the change in accounting policy. The resolution of the Board Audit Committee of 4 November 1993 approved the change in accounting policy. On 24 November 1993 the SFF Board noted that the Board Audit Committee had approved the change in the accounting policy. On 7 February 1994, Mr Vorster and Mr Hefer

signed the revised annual financial statements and Price Waterhouse signed the audit report.

5.21 The loss of R170 million in the 1992/3 financial statements, described as “Results of Strategic Stock Transfers”, was referred to in Minister Maduna’s responses in Parliament on 18 June 1997 as detailed in the first chapter of this report.

ALLEGATIONS

5.22 A number of allegations in respect of the change of accounting policy were made:

- The R170 million disclosed as the Results of Strategic Stock Transfers in the 1992/3 SFF financial statements was a physical loss.
- The new accounting policy was in contravention of Generally Accepted Accounting Practice (GAAP).
- The accounting policy was changed to “hide” profits from the “new Government”.
- There was no evidence that the Board of Directors approved the change in accounting policy.
- The original 1992/3 financial statements were not properly withdrawn.
- The Auditor-General and his agents did not perform a proper audit in relation to the change in accounting policy.
- Utilising the secrecy provisions the effects of the accounting policy change were deliberately not disclosed to Parliament and to the Minister.

5.23 These allegations have been addressed below.

The R170 million disclosed as the Results of Strategic Stock Transfers in the revised 1992/3 SFF financial statements was a physical loss

5.24 During the initial hearings of this investigation in June 1998, Counsel for the Minister put on record that the R170 million was not a physical loss as the Minister had indicated in his responses in Parliament, but an accounting loss caused by the change in accounting policy.

The new accounting policy was in contravention of Generally Accepted Accounting Practice

5.25 The change in accounting policy and its disclosure in the 1992/3 financial statements are highly technical matters. Without going into the technicalities of accounting, I understand that the change in accounting policy relating to strategic stock and its disclosure are regulated by various accounting standards laid down by the South African Institute of Chartered Accountants (SAICA) and where applicable international and industry specific accounting practices, guidelines and standards. However, I also understand that these are open to a certain amount of expert interpretation depending on the specific application. As such the reasonableness of the change in accounting policy would be a matter of expert opinion.

5.26 Considering and evaluating the accounting policy change was only necessary for as long as it appeared that the R170 million was a physical loss. Given that there was no physical loss associated with the change in accounting policy, I do not feel that the public interest would be served by lengthy expert argument over whose opinion with regard to the accounting policy is correct.

5.27 However I note that the change in accounting policy and its disclosure was considered by several highly qualified Chartered Accountants. Mr Vorster in his evidence highlighted those involved and their qualifications, who included:

- Mr Cilliers (Chartered Accountant, SFF Deputy General Manager: Finance);
- The SFF Board Audit Committee
 - Mr Hefer (Chartered Accountant, audit firm partner, previous member of the Accounting Practices Board),
 - Mr Paddock (Chartered Accountant, retired Financial Director), and
 - Mr MacDonald (Chartered Accountant, Financial General Manager of the Industrial Development Corporation, previous member of the Accounting Practices Board);
- Mr Van der Nest (Chartered Accountant, Price Waterhouse audit partner);
- Mr Van Zyl (Chartered Accountant, General Manager: CEF/SFF).

5.28 In addition he noted that advice was sought from the Technical Department of Price Waterhouse as well as the Office of the Auditor-General regarding the proposed changes to the accounting policy.

5.29 As such I am of the opinion that the process followed and the expertise utilised in considering the change in accounting policy and its disclosure was reasonable.

5.30 If there are still concerns or queries with regard to this accounting policy, the Minister is entitled to request the Board to review this matter further and obtain further expert advice in this regard.

5.31 Chapter 11 of the Public Finance and Management Act 1 of 1999 provides for the establishment of an Accounting Standards Board, which functions include:

“89(1)(a) Set standards of generally recognised accounting practice as required by section 216(1)(a) of the Constitution, for the annual financial statement of -

- (i) departments;*
- (ii) public entities;*
- (iii) constitutional institutions;*
- (iv) municipalities and boards, commissions, companies, corporations, funds or other entities under the ownership or control of a municipality; and*
- (v) Parliament and the provincial legislatures.*

(b) prepare and publish directives and guidelines concerning the standards set in terms of paragraph (a) ...

(2) In setting standards the Board must take into account all relevant factors, including -

- (a) best accounting practices, both locally and internationally; and*
- (b) the capacity of the relevant institutions to comply with the standards.”*

5.32 As such in future government accounting standards will be much clearer and if required, changes in accounting policy can be checked with the Accounting Standards Board to ensure that they fully comply with Generally Accepted Accounting Practice.

5.33 The Public Finance and Management Act has pre-empted whatever recommendations I was inclined to make in this regard and I am of the

view that it adequately addresses the question of government accounting standards now and in the future.

The accounting policy was changed to “hide” profits from the “new Government”

5.34 The Price Waterhouse working papers noted that:

“The board has now decided to defer these profits, since they believe that they may well be forced (by a new government) to sell some of these stocks, possibly at a loss.”

5.35 Price Waterhouse testified that this was written by a more junior member of the team and purely indicated the concern that if stock was valued at higher prices there was a greater risk that the value could fall below this level and hence if oil was sold it may realise a loss. The new accounting policy, by keeping the replacement stock at the historical, much lower value of the original stock, removed this problem as it was unlikely that the oil price would drop to those historical low levels.

5.36 Mr Vorster confirmed that the change in accounting policy did not affect the actual cash flow of the SFF business on which the payments to Government are calculated. The profits realised from selling the strategic stock were utilised in replacing it. As such the profits initially recognised prior to the accounting policy change were not available in cash to be paid out.

5.37 As such I find that there is no evidence that the accounting policy was changed to hide profits from the new Government.

There was no evidence that the Board of Directors approved the change in accounting policy

- 5.38 NSN contended that the Board Audit Committee was the CEF Board Audit Committee and not the SFF Board Audit Committee and that the Board Audit Committee was not mandated to finalise the 1992/3 SFF financial statements. They also contended that the Directors were not authorised to sign the financial statements. However, from the evidence it appears clear that the Board Audit Committee operated for all the CEF group of companies. NSN do not dispute that in practice this is how it worked.
- 5.39 It is common cause that there was no minute of the Board authorising the Board Audit Committee to finalise the 1992/3 financial statements or the Directors to sign the financial statements prior to the financial statements being signed on 2 September 1993. However it appears clear from the Board meeting of 21 September 1993 and the relevant submissions that the Board had effectively mandated the Board Audit Committee to finalise the financial statements.
- 5.40 It is also common cause that in all other years relevant to this enquiry, namely 1991/2 onwards, that the Board Audit Committee was mandated to finalise the financial statements and that the Chairman and a member of the Board Audit Committee signed the financial statements.
- 5.41 The Board Audit Committee also authorised the change in accounting policy and the same Directors signed the revised financial statements on the same basis.
- 5.42 I am of the opinion that whilst technically there were some minor deficiencies with the documentation of the various authorisations required to finalise the 1992/3 financial statements, practically the financial statements (both initial and revised) were reviewed and approved in a reasonable manner. These deficiencies, whilst they

cannot be condoned (I have addressed these under Corporate Governance), had no impact on the normal operations and functioning of SFF.

The original 1992/3 financial statements were not properly withdrawn

5.43 It is common cause that the original 1992/3 financial statements were not formally withdrawn. However it is also common cause that the original financial statements were not circulated outside SFF and its auditors, all of whom were aware that the original financial statements had been superceded. All the interested parties were aware of the reasons for the withdrawal and were in agreement with those reasons. I am therefore of the opinion that the process followed in this regard, whilst not one hundred percent correct, was acceptable.

The Auditor-General and his agents did not perform a proper audit in relation to the change in accounting policy

5.44 This issue is dealt with in the chapter on Audit Work below.

The effects of the accounting policy change were deliberately not disclosed to Parliament and to the Minister

5.45 While the amount of R170 million was separately disclosed in the audited financial statements, the Auditor-General's report presented to Parliament included the amount in the nett trading income from strategic and commercial crude. This matter is dealt with in the chapter on the Auditor-General's reports to Parliament.

6. R1 450 MILLION PAYMENT ON 1 APRIL 1997

BACKGROUND

6.1 Section 1(2)(b) of the Central Energy Fund Act 38 of 1977 states that:

“Any such moneys which in the opinion of the Minister of Mineral and Energy Affairs –

- (i) are not immediately required for a purpose mentioned in paragraph (a) , shall be invested in such manner as the said Minister with the concurrence of the Minister of Finance may determine,*
- (ii) are not required for any such purpose, shall be paid into the State Revenue Fund.”*

6.2 The SFF makes payments to the Government in terms of this provision with regard to monies generated from strategic oil sales and the commercial profit that has been generated in trading oil. The payments are based on cash flow forecasts that estimate the amount of money the SFF can afford to pay.

6.3 The cash flow forecasts take into account the following major factors in estimating the cash that will be available:

- Opening and closing cash and stock position;
- Sales of oil;
- Repurchases of oil;
- Other cash amounts relating to oil trading such as interest, letter of credit costs, etc;
- Company cash requirements.

- 6.4 The information is provided by various relevant departments and put together by the Finance Department. The cash flow forecast is based on a number of assumptions such as when oil will be sold and repurchased and the likely price of oil at the time, etc, and as such are subjective. The cash flow forecasts generally show the cash position on a monthly basis.
- 6.5 Originally, as detailed in a facsimile dated 3 February 1997, R650 million was to be transferred to the Government on 1 April 1997 in relation to sales of strategic oil, plus an additional amount of R200 million in relation to commercial oil sales, followed by R150 million on 1 April 1998. On 25 February 1997 another facsimile was compiled amending the amounts to be paid to a once off payment of R1 250 million relating to strategic oil sales plus the R200 million from commercial oil sales.
- 6.6 On 1 April 1997 a payment was made to the Government (Department of Finance) of R1 450 million. The R1 450 million payment was broken down into two parts: R1 250 million with regard to strategic oil sales and R200 million with regard to profits generated from commercial oil trading. The R200 million from the commercial oil trading has not been disputed and therefore only the R1 250 million payment in respect of the strategic oil sales has been considered.

ALLEGATIONS

- 6.7 The following allegations with respect to this payment have been made:
- Full information on the increase in the transfer to the Government was not provided to the Board of Directors, prior to its approval. The SFF was left short of cash, as the transfer was based upon oil sales that had not yet occurred. This was in contravention of Company Policy R05.

- The audit should have identified problems with this payment.
- The strategic oil reserves fell below the required number of 39 million barrels as at 31 March 1997.

Full information on the increase in the transfer to the Government was not provided to the Board of Directors prior to its approval. The SFF was left short of cash as the transfer was based upon oil sales that had not yet occurred. This was in contravention of Company Policy R05

- 6.8 Extensive evidence was given on the expected cash flow shortage caused by the R1 450 million payment made to the Government on 1 April 1997. Specifically it was noted that the cash flow forecasts assumed that return cargoes would be funded out of future sales, rather than the funds being set aside from the initial sale that the return cargo was intended to replace. This effectively meant that the monies for the return cargoes were available to be paid to the State.
- 6.9 SFF is a risk adverse company. As such when trading with oil they do not hold open positions. An open position is when oil is sold without a contract being entered into to repurchase the oil. This means that there is uncertainty at what price the oil will be replaced as the oil price might go up or down before the oil is repurchased. SFF entered into back to back contracts ie they did not sell oil without entering into a contract to repurchase the oil in the future at an agreed price. This meant that the profit on the overall transaction was known. (When the market allows oil to be sold now and a contract entered into to repurchase at a future date at a lower price, the market is said to be in backwardation.)
- 6.10 It was argued that by paying out monies to the State, without putting aside funds for the repurchase of oil already sold, there was a possibility that funds would not be available when the cargo was returned – if for

instance the future sales happened later than forecast or the return cargo was earlier.

- 6.11 The Auditor-General and Price Waterhouse noted that Company Policy R05 was revised in December 1997, after the payment. The old R05 policy stated in paragraph 7 that:

“The proceeds from the sales transactions form part of the strategic investment portfolio.”

- 6.12 This effectively meant that the funds were available to be paid to the State assuming that the cash flow indicated sufficient funds were available.

- 6.13 The revised R05 stated, in addition to the above:

“These funds may not be used for any other purpose, and may not be invested in such a manner as to preclude the earlier than originally planned return date of the cargo.”

- 6.14 This in effect prevented the payment to the State of funds held for return cargoes.

- 6.15 Given that the old RO5 policy was silent on whether funds for return cargoes should be retained, I find that the payment to the State was not in contravention of the policy. As the new policy is explicit that the funds must be set aside from the original sale, I have made no further recommendation in this regard.

- 6.16 Extensive evidence was heard on the various cash flow forecasts that were prepared in the lead up to this payment to the State, the differences between them and why the amount to be paid to the State

was revised upwards. In particular it was noted that one of the monthly cash flow forecasts showed a short term cash deficit, but that the cash flow presented to the Board was an annualised forecast and did not show the short term cash deficit.

6.17 It was confirmed by Dr Roberts, that whilst initially it appeared as though the company would suffer a cash flow shortage, due to the size of the payment to Government, in fact no shortage occurred as the following factors changed:

- Strategic stock levels were reduced, thus releasing additional cash.
- Exchange cargoes were repurchased at a later date than originally planned.

6.18 However, it was also confirmed that even if these factors had not changed there would have been sufficient funds within the SFF organisation to fund the shortfall.

6.19 It is common cause that there was no actual cash shortage caused by these payments. Given this and the fact that the cash flow forecasts are exactly that, forecasts, and are therefore subjective, I did not consider it necessary to go into further detail on the various cash flow forecasts prepared and the differences between them. However, I do recommend that if a cash flow shortage is forecast, even a short term one, this should be clearly communicated to the Board so that the matter can be addressed in whatever manner deemed appropriate by the Board.

The audit should have identified problems with this payment

6.20 This issue is dealt with in the chapter on Audit Work below.

The strategic oil reserves fell below the required number of 39 million barrels as at 31 March 1997

6.21 It was also noted that the strategic oil reserves fell below the required number of 39 million barrels as at 31 March 1997. As at that date the strategic oil reserves were required to be equal to 3 months usage. This had been equated to 39 million barrels. As at 31 March 1997 only 26.4 million barrels were physically held (wet barrels). In addition 11 million barrels had been contracted for (paper barrels) and 6.1 million barrels were in transit.

6.22 Both Company Policy R02 and R05 provide details of the volume of stock that can be traded. Company policy R02 states:

“It is SFF policy to optimally manage the strategic crude oil reserves by trading with volumes which do not exceed 5% of the minimum stock level.”

6.23 The policy changed on 4 December 1997 to allow 2 very large cargo carriers (VLCC's) to be traded at any time. Company Policy R05 indicates that 2 VLCC's can be used for trading.

6.24 Mr Pithey and Mr Van Zyl noted in their evidence that each oil trade and its affect on stock was motivated by the Crude Oil Department and considered at the highest levels prior to it being entered into. However, Mr Pithey detailed that he was not aware of the policy and relied upon Mr Casey to identify any breach of company policy.

6.25 Mr Van Zyl argued that the company policy is silent as to whether strategic oil reserves must be held physically (wet barrels) or can be held in future contracts (paper barrels). The Auditor-General and Price Waterhouse noted that paper barrels were only acquired once strategic

stock was traded and as such this meant that a maximum of 5% (2 VLCC's) could be held in paper barrels. Two VLCC's equate to 3.6 million barrels. As 11 million barrels were held in paper, I am of the opinion that Company Policy R02 was in fact not complied with.

- 6.26 It does not appear to make sense that strategic stock is held in future contracts as these contracts may not be fulfilled in the circumstances that give rise to the strategic stock being required, hence the requirement that only a limited amount of stock can be traded. However, I note that strategic stock levels were in the process of being reduced and were in fact reduced in June 1997. As such the breach of the policy did not in this instance have any serious consequences for the SFF or South Africa. I do not by so saying, seek to justify the aforementioned breach, which potentially could have had serious consequences for the country. Such a breach should never be countenanced or allowed to occur in the future.

7. CORPORATE GOVERNANCE

7.1 Corporate Governance is a very broad term. The King Report on Corporate Governance provides best practice in South Africa on Corporate Governance Practices. The King Report defines Corporate Governance as:

“simply the system by which companies are directed and controlled.”

7.2 The King Report goes further to say that:

“In the context of corporate governance, a proper balance needs to be achieved between freedom to manage, accountability and the interests of the different stakeholders.”

7.3 I have referred to specific sections of the King Report as required below.

KEY ALLEGATIONS

7.4 Corporate Governance is a very broad topic. As such any allegation relating to improper conduct of any individual at the SFF, incorrect documentation, poor controls, etc, is a Corporate Governance allegation. Some of these allegations have been dealt with specifically in the appropriate key issue sections. This section has looked at the Corporate Governance allegations on a broad basis and where applicable has grouped together allegations of a similar nature.

7.5 The key allegations are:

- The SFF Board of Directors did not correctly mandate the committees.

- The minutes of the Board and the various committees were not kept properly.
- Mr Van Zyl acted without the appropriate authority and knowledge of the Board and did not provide them with adequate information regarding the key issues.
- Mr Van Zyl did not allow Internal Audit to operate in a fully independent way as required.
- Various other allegations against Mr Van Zyl.
- The SFF Board of Directors did not fulfil their management role or ensure proper Corporate Governance in respect of the key issues.

7.6 I intend taking each of the allegations noted above in turn.

BACKGROUND TO SFF CORPORATE GOVERNANCE

The Board of Directors

Applicable legislation

7.7 The Central Energy Fund Act 38 of 1977 provides in section 1(3) and (4):

“(3) The affairs of the CEF (Proprietary) Limited shall be managed and controlled by a board of directors.

(4) The board of directors referred to in subsection (3) shall consist of –

(a) a chairman appointed by the Minister of Mineral and Energy Affairs for a period not exceeding five years on such conditions, including conditions relating to remuneration and allowances, as the said Minister may, with the concurrence of the Minister of Finance, determine, and who may be reappointed;

- (b) *two officers in the Department of Mineral and Energy Affairs appointed by the Minister of Mineral and Energy Affairs, one of whom, in the opinion of the said Minister, possesses expert knowledge of crude oil supply and fuel matters; and*
- (c) *not more than five other directors appointed by the Minister of Mineral and Energy Affairs on such conditions, including conditions relating to remuneration and allowances as the said Minister may, with the concurrence of the Minister of Finance, determine.”*

7.8 Sections 1E(1) and (2) of the CEF Act 38 of 1977 state the following:

- “(1) The chairman of the Board of directors of the CEF (Proprietary) Ltd shall be the accounting officer charged with the responsibility of accounting for all money received by CEF (Proprietary) Ltd or the SFF Association, and for all payments made by CEF (Proprietary) Ltd out of the Central Energy Fund and the Equalisation Fund and other payments made by the CEF (Proprietary) Ltd or the SFF Association.*
- (1) The accounting officer shall –*
 - (a) keep full and true records of all transactions entered into by the CEF (Proprietary) Ltd for the account of the Central Energy Fund or the Equalisation Fund and of all other transactions of CEF and the SFF;*
 - (b) cause the books and accounts relating to the transactions referred to in paragraph (a) to be balanced as at the thirty-first day of March in each year;*

(c) *after the balancing referred to in paragraph (b) prepare, in respect of the Central Energy Fund, the Equalisation Fund, CEF and the SFF, separate statements of income and expenditure for the preceding financial year and balance sheets showing their assets and liabilities as at the end of that financial year.”*

7.9 These sections remained the same after the amendments to the said Act in 1994.

7.10 The King Report, chapter 4, outlines the responsibilities of a Board of Directors and states that:

“The board must be in a position to lead, control and monitor the business of the company. The board has a collective responsibility to provide effective corporate governance.”

Fiduciary responsibilities of Directors at SFF

7.11 In addition to any specific responsibilities outlined in the CEF Act, all directors have an obligation to act in the best interests of the company and its shareholders. This is known as their fiduciary duty. This is outlined both in the Companies Act and common law.

7.12 The NSN’s first report outlines the specific fiduciary duties of a director as:

- *“Exercise their powers independently and objectively;*
- *Exercise these powers for the purpose for which they were conferred;*
- *Operate within the limits of their authority;*
- *Act legally and honestly;*

- *Act bona fide in the interest of the company and not for any personal, ulterior or improper purpose.”*

7.13 The NSN report further highlights the duty of care and skill of the Directors of SFF:

“All directors are required by law to exercise the necessary care, skill and diligence in the performance of their duties. The necessary caution and concern must be applied when exercising company’s powers and safeguarding the company’s assets.”

Types of Director

7.14 Generally directors are placed into two broad categories:

- *Executive Director:* a director who is involved hands on in the day to day running of the business; and
- *Non-Executive Director:* a director who is not involved in the day to day running of the business, but performs a more high level advisory role.

The SFF Board

7.15 During the time relevant to this enquiry the composition of the Board was as outlined below.

7.16 Prior to March 1992 the CEF and SFF Boards were separate. The CEF Board contained additional members than the SFF Board, but all the SFF Board members were also on the CEF Board. Both the SFF and CEF Boards were made up of people from the Industrial Development Corporation (IDC) and the Department of Minerals and Energy Affairs. The SFF Board consisted of:

- DR Vorster IDC (Chairman);

7.21 The CEF Board Audit Committee acted as Audit Committee for the affairs of both SFF and CEF and consisted of the following people:

- Mr Hefer
- Mr Paddock
- Mr MacDonald.

7.22 The Charter of the Board Audit Committee details the responsibilities of the Board Audit Committee as:

“ Consider and review with the independent auditor and manager of internal auditing:

- *The adequacy of the company’s internal controls including computerised information system controls and security;*
- *Any related significant findings and recommendations of the independent auditor and internal auditing, together with management’s responses thereto.”*

7.23 In a large organisation the Board members cannot control the business effectively on their own. They must delegate authority to various committees, departments and individuals to assist them.

7.24 The key structures at the SFF were as follows:

- *The Board:* The Board is assisted by various committees as detailed above. This is in line with the recommendations in the King Report (chapter 11 and chapter 13 with respect to Board Audit Committees).
- *Management :* Key management of the SFF consists of the General Manager and Deputy General Managers for the key departments in the organisation such as Finance, Crude Oil, etc. The Deputy General Managers report to the General Manager and the General Manager to the Board. In practice both the Deputy General

Managers and the General Manager present information to the Board to enable the Board to make informed decisions.

- *Internal Audit:* As detailed in the chapter on Audit Work of this report, Internal Audit reports to Management/the Directors of the company. They are there to assist Management to ensure that the controls in the business are adequate and operating correctly and therefore the business is being correctly controlled. Internal Audit assesses the risk of the business, reviews the adequacy of the controls to mitigate the risk and tests the controls to ensure their correct operation. The King Report, chapter 14, stresses the importance of the internal audit function and its independence.

7.25 SFF Internal Audit reports to the Internal Audit Committee, which reports to the Board Audit Committee. Internal Audit is headed by the Internal Audit Manager who reports to the General Manager. The Internal Audit Committee under the chairmanship of the General Manager has the following members:

- Deputy General Manager Finance
- Internal Audit Manager
- Specialists as required from time to time, whilst the External Auditors attend by invitation.

7.26 The mandate of the Internal Audit Committee details the responsibilities of the Committee, which include:

- To review the accounting policy proposed by Management in respect of the implementation thereof;
- To review all procedures and approve these procedures prior to their being presented as part of the manual;
- To review the reports of the Internal Audit Department and actions taken on the basis of the reports;

- To review the reports of the Internal Audit Manager presented to the Board Audit Committee.

Reporting to the Minister

7.27 Section 1E(6) of the Central Energy Fund Act 38 of 1977 states that:

“ The chairman of the board of directors of the CEF (Proprietary) Ltd shall furnish the Minister of Mineral and Energy Affairs with such information as the Minister may from time to time call for relating to the activities of the CEF (Proprietary) Limited and the SFF Association or relating to the transactions entered into for account of, or the financial state of, the Central Energy Fund, the Equalization Fund or any other account of CEF (Proprietary) Limited or the SFF Association.”

7.28 Whilst the Minister is external to the CEF group he has ultimate control of the group as representative of the shareholder (namely the Government). As such he is also an integral part of the Corporate Governance structure of the entity.

The SFF Board of Directors did not correctly mandate and control the various Board committees

Crude Oil Committee

7.29 NSN alleged that the Board of Directors did not approve nor mandate the establishment of the Crude Oil Committee from the period 1 April 1992 to 24 November 1993 when it was dissolved, nor did the Crude Oil Committee report to the Board.

7.30 NSN further questioned the need for the secrecy when sanctions were being eased in 1992 and the SFF able to enter into direct contracts by the time the Crude Oil Committee was set up. However, I note that

whilst the relaxation of sanctions allowed the CEF and SFF Boards to be combined, given that conditions of secrecy still existed it appears reasonable that the Crude Oil Committee continued to control matters with regard to crude oil. This has been dealt with in paragraphs 3.82 to 3.84 above.

Board Audit Committee

7.31 NSN alleged that the Board Audit Committee was not mandated to finalise the 1992/3 SFF financial statements. This has been dealt with in the chapter on the Change in Accounting Policy (R170 million issue) above.

The minutes of the Board and the various committees were not kept properly

7.32 Several times during this investigation, it was noted that the Board minutes or the Crude Oil Committee minutes did not include details of things that were supposedly discussed at those meetings, in particular the Interstate contract. The latter issue has been dealt with in detail in paragraphs 3.96 and 3.97 above.

7.33 I must emphasise that Board and Committee minutes evidence the control that the Board and Committee members have over the business of the company and therefore it is vital that they record all matters of importance. I recommend that the Directors and Committee members when checking minutes ensure that they fully record the matters of key import with regard to the management of the business and key decisions in this regard.

Mr Van Zyl acted without the appropriate authority and knowledge of the Board and did not provide them with adequate information regarding the key issues

7.34 These allegations were raised particularly in respect of the Interstate payments, the change in accounting policy and the R1 450 million payment to Government. However, in all cases Mr Vorster and Mr Pithey confirmed that Mr Van Zyl had acted with their full knowledge and consent and that at all times they and the Board/Crude Oil Committee were fully aware of all the matters. As such no blame in this regard can attach to Mr Van Zyl.

7.35 These allegations appeared to arise primarily due to Mr Van Zyl's unique position as General Manager making him the lynch pin between management (the Deputy General Managers and their departments) and the non-executive Board. This led to concerns that the Board were provided with limited/incorrect information by Mr Van Zyl. Both Mrs Joubert and Mr Casey specifically stated that they felt that the information flow to the Board was limited by Mr Van Zyl as he reviewed all submissions by the Deputy General Managers to the Board and that the Deputy General Managers did not feel able to speak out at Board Meetings. I note however that neither Mrs Joubert nor Mr Casey provided details of any specific instances where they were asked to limit information.

7.36 The King Report, chapter 4, sections 6 to 9 states the following:

“6 In monitoring the activities of the executive management the checks and balances set up in a company by the board are important. It is one of the means of ensuring that the information which is considered at board meetings is as accurate as possible and not skewed by the wishes of a

particular executive and, more importantly, is not false in any respect.

- 7 *Similarly a board should not be dominated by an individual or individuals, so as to ensure that an objective and intellectually honed collective mind is brought to bear on decisions... One of the ways of attaining accuracy of reporting is to have a senior member of management who is not a board member report on their sphere of operations. The board can then direct questions to them and check the answers against the content, trend or tone of the written reports before the board.*
- 8 *Non-executive directors have, as part of their duties four important functions. They need to bring their special expertise and knowledge to bear out the strategy, enterprise, innovative ideas and business planning of the company... Secondly, they can monitor and review the performance of the executive management more objectively than can be done by the executive directors. Thirdly, they can play a role in resolving conflict of interest situations... Fourthly, they can act as a check and balance against the executive directors.*
- 9 *For these reasons a board needs to be balanced with at least an equal number of executive as non-executive directors. Obviously the chair plays a vital role and should be independent and non-executive. Where there is not such a chair, there should be at least two non-executive directors of such calibre that they would carry significant weight in that board's deliberations and resolutions. Whilst it is preferable to balance the board, with an appropriate mix of skills and expertise among the non-executive directors, it must be accepted that it may not always be practical in South Africa.* (My underlining.)

7.37 If the SFF had had both Executive and Non-executive Directors then the flow of information between Management and the Board would not have been open to potential limitations by one person as was alleged. I therefore recommend that the SFF Association and other similar Government organisations should have a Board of Directors consisting of Executive and Non-Executive Directors, as recommended by the King Report. This would not necessarily require additional people. I would expect that the non-executive Board could remain, but that the General Manager and Deputy General Managers be appointed Executive Directors. This would prevent the Board being dominated by an individual or individuals whilst ensuring that it is fully informed on all matters at all stages. The Chairman would however continue to be independent and non-executive.

Mr Van Zyl did not allow Internal Audit to operate in a fully independent way as required

7.38 Internal Audit assesses the adequacy of controls and the compliance with them. It is vital that Internal Audit can act and report with complete independence so that no one can inappropriately affect the work performed or the reporting thereon.

7.39 Independence is a state of mind, which is vital to all auditors. External Audit is completely independent of the company. Internal Audit whilst reporting to the Board should also be independent. Independence means that Internal Audit should feel free to perform and report on the work they deem reasonable. As Internal Audit is there to assist the Board to ensure correct Corporate Governance, the Board may limit Internal Audit or focus their work. However, Internal Audit should be free to highlight any disagreement or limitations placed on their work if they believe it necessary.

7.40 In this case Internal Audit reports to the General Manager, the Internal Audit Committee and the Board. The SFF Internal Audit performed two main functions:

- The normal internal audit function of assessing the adequacy of controls and testing the compliance; and
- Prior to crude oil payments being effected, verifying that all appropriate authorisations had been obtained and that the payment was in terms of a valid contract. This has been referred to as the “line function” as the authorisation of Internal Audit was part of the control function, rather than just a checking control after the event.

7.41 Much has been made of the difference between the “normal” and “line” internal audit function. However, the only difference appears to be that compliance with controls is tested retrospectively in the normal internal audit function and currently in the line function.

7.42 Mrs M Joubert first became aware of the Interstate payments as an Internal Audit assistant. She queried the existence of a contract, but was told by her manager, Mr P Van Den Berg, that it could be approved. As an assistant Mrs Joubert was entitled to rely upon her manager in this regard. Mr Van Den Berg in an interview with NSN stated that he had approved the payments to Interstate despite the fact that there was no contract as he regarded each “leweringsgoedkeuring” (delivery approval document) as a contract. On the basis that the Chairman and General Manager approved it, he was satisfied that the payments were properly authorised. (NSN noted that the Interstate payments were not always included in this document for various shipments during 1996, but were prior to 1996).

7.43 When Mrs Joubert was appointed Internal Audit Manager the line function regarding crude oil payments was retained by Mr P Van Den

Berg who had then become head of Human Resources. Mrs Joubert felt that there was something suspicious about the crude oil line function not remaining with the Internal Audit Manager on her appointment. Mr Van Zyl detailed in his evidence that it was preferable that Internal Audit did not have a line function and as such when there was an opportunity to split the roles he did so. However, when Mr Van Den Berg left this function had to revert to Internal Audit, as there was no other independent person with sufficient knowledge to perform this role.

7.44 From 1 September 1996, when Mr Van den Berg left SFF, the line function returned to Mrs Joubert. She again queried whether the Interstate payments were made in terms of a valid contract and was told by Mr Casey that no contract existed.

7.45 Mrs Joubert in her letter to NSN dated 9 June 1997 stated:

"I was not comfortable with it... My action was to request Mr Casey to include this premium in future in the delivery approval document, this document must be signed by the Chairman. This was the best action I could take, because I am reporting to the General Manager who clearly supported these payments. If I would refuse to approve these payments or query these payments, action would be taken against me and these payments will still continue..."

The reporting to the Board Audit Committee on audit findings were done after the Internal Audit Committee meeting reviewed the submissions to the Board Audit Committee and I was not supposed to deviate from this, there must not be any 'surprises' in my submission to the Board as stated by the General Manager. "

- 7.46 She further noted that the Board Audit Committee was not informed of the changes with regard to the crude oil line function. Mrs Joubert did not report the lack of a contract or the limitation in her scope of work to anyone else.
- 7.47 Mrs Joubert detailed in her evidence to me that she felt that she was not able to report independently regarding the lack of a valid contract for the Interstate payments as Mr Van Zyl would fire her if she did, or at least make life very difficult. She specifically noted that she was appointed as Manager: Internal Audit by Mr Van Zyl and not the Board as was required, and felt therefore that he would be able to fire her. She also said that his management style was intimidating. However Mrs Joubert confirmed that Mr Van Zyl had never asked her to exclude any matter in her reporting and had never threatened her in any way.
- 7.48 Mr John Ferris, member of the Internal Audit Committee, specifically stated that Mrs Joubert had ample opportunity either formally within Internal Audit Committee meetings (when management was specifically asked to leave the Internal Audit Committee meeting), or informally at other times to report any concerns that she had in this regard.
- 7.49 I do note that Mrs Joubert had the following concerns:
- there may be involvement of one or more of the Directors with regard to the Interstate issue as they had authorised the payments;
 - the Directors would support Mr Van Zyl with regard to this matter; and
 - this matter had not been reported by her predecessor.
- 7.50 This placed her in a difficult position. Whilst I understand and sympathise with these difficulties, it is vital that Internal Audit acts independently. Mrs Joubert did take some action to ensure that the

Interstate payments were valid in that she asked Mr Casey to ensure they were included on the approval documentation signed by the Chairman. However, given the lack of any requests for her to omit the limitations on her work with regard to locating a written Interstate contract, Mrs Joubert should have included this matter in her reporting so that it could be directly addressed.

Other allegations against Mr Van Zyl

7.51 These matters were dealt with in the investigations with regard to Mr Van Zyl's disciplinary hearing and as such I have not investigated it further.

The SFF Board of Directors did not fulfil their management role or ensure proper Corporate Governance in respect of the key issues above

7.52 Corporate Governance is not an absolute. What is required to adequately control a company varies from company to company and from year to year depending on the situation of the company.

7.53 SFF is unique in that in the sanctions era its primary function was to break sanctions. This necessitated secrecy in most if not all aspects of the business. Good Corporate Governance requires open communication and transparency at all levels. Generally if communication is open and transparent, even if other controls fail or are circumvented, even at the highest level, this will be detected and reported either through official or unofficial channels so the matter can be addressed. This was obviously not possible when secrecy was required and therefore other controls needed to be even better to make up for this.

7.54 Mr Casey stated that the previous Chairman, Mr Vorster, was more vigorous than Mr Pithey who replaced him in March 1994. Mr Casey

referred to Mr Pithey as a “rubber stamp”, which Mr Pithey took issue with in his evidence. Mr Vorster, whilst being a non-executive Chairman, stated that he spent almost 50% of his time on SFF and performed some executive functions, as SFF was a high risk organisation due to the clandestine nature of their work. He authorised all crude oil purchases and was involved in negotiating crude oil contracts.

7.55 As sanctions were relaxed and then lifted communication could become more open. Crude oil purchasing could be done in a more open manner. When Mr Pithey became Chairman in 1994, sanctions had already been lifted and therefore SFF was not such a high-risk company. The main concern at CEF during Mr Pithey’s tenure was MOSSGAS. As such Mr Pithey spent more time on MOSSGAS and less on SFF, relying on his management team.

7.56 Generally the Board and management will prioritise high risk and problem areas in their management of the business. Both Mr Vorster and Mr Pithey were aware of Mr Van Zyl’s self-confessed hard management style and on occasion disagreed with him. However neither of them were aware of any specific allegations against Mr Van Zyl that would have led them to increase their focus and control on SFF. I believe that overall therefore Mr Vorster and Mr Pithey acted correctly with regard to the priority that they gave SFF during their tenures as Chairmen.

OTHER CORPORATE GOVERNANCE ISSUES

7.57 One of the key concerns during this investigation was that the SFF/State has lost money due to fraudulent or inappropriate actions. Around the world there is an increasing concern about fraud. South Africa during the sanctions era was particularly exposed to the risks of fraud. State institutions such as SFF were specifically tasked with breaking sanctions

and operated in a secret environment. Communication was limited and opportunities existed for fraud. The sanctions era has ended and the age of transparency is upon us. However, mistrust still exists of those institutions that supported the Apartheid regime and the individuals working for them.

7.58 These State institutions must be transparent with regard to their handling of state assets. There is no excuse for secrecy or non-disclosure in most spheres of Government. State institutions should review themselves to ensure that in all matters they are above reproach. This is particularly important where particular contracts or relationships formed during the sanctions era may still be continuing but not be applicable to the post sanction era.

7.59 State institutions should form the model for good Corporate Governance. Whilst these institutions do not always operate in the same way as a normal business, the Corporate Governance principles outlined in the King Report are still applicable . Given the highlighting of fraud in business today, it is vital that as part of this Corporate Governance that fraud is specifically addressed. I therefore recommend that all State Institutions should have a formalised fraud strategy as part of their overall strategy, which should include:

- How fraud risks will be assessed on an ongoing basis;
- An ongoing methodology for ensuring that the controls in place correctly identify, deter and prevent fraud;
- A fraud response plan to ensure that any fraud detected is responded to appropriately;
- Specific responsibilities for ensuring that the fraud strategy is implemented and followed up on an ongoing basis.

- 7.60 A fraud response plan should include details of the relevant reporting structures appropriate for employees and others to the Board and Minister. It should also detail who will follow up and investigate any potential fraud. I note that the Auditor-General's office has a fraud investigation/forensic unit that could assist in this regard. An appropriate fraud response plan may have mitigated the problems that arose when the Minister had suspicions, but no formal policy was in place on which he could base his actions.
- 7.61 It is vital that the fraud strategy is a live strategy. Generally I would expect that as part of the strategy State institutions would have a code of conduct, fraud awareness training and a communication plan to ensure that all employees, suppliers and customers are aware of their responsibilities with regard to fraud and have a method to communicate any potential problems identified.
- 7.62 Whilst it is up to the State institutions to get their house in order, it is also vital that all parties cast aside their prejudices from the Apartheid era and work together with free and open communication to ensure that potential wrongdoing is uncovered and is not aided by an us and them mentality.

8. AUDIT WORK

APPOINTMENT OF THE AUDITOR

8.1 The Auditor-General was appointed to audit SFF as part of the CEF group of companies in terms of the Central Energy Fund Act 38 of 1977.

8.2 Section 1E(3) of that Act states:

“the books, accounts, statements and balance sheets referred to in subsection (2) shall be investigated, examined and audited by the Auditor-General.”

8.3 The Auditor-General’s office operates within the Auditor-General Act (initially Act 52 of 1989, as amended by Act 66 of 1990 and Act 123 of 1992 and after its repeal, Act 12 of 1995). The quotes below are from the 1995 Act. Any major differences in the 1989 and 1995 Acts where relevant to this enquiry have been noted where appropriate.

8.4 Under sections 6 and 9 of the Auditor-General Act, the Auditor-General may delegate or assign any power or duty. Price Waterhouse was the appointed agent of the Auditor-General with respect to the audit of SFF for the period relevant to this enquiry, namely the financial years 1991/2 – 1996/7.

8.5 The agent is controlled by an Audit Controller at the Office of the Auditor-General. The terms of reference for the agent are indicated in a letter from the Auditor-General to the agent, which include guidelines on the standards of auditing and reporting issued by the Auditor-General. These are referred to below as the Auditor-General’s Guidelines.

8.6 The Auditor-General’s reporting therefore can be split into two phases:

- The audit work of Price Waterhouse, the agent of the Auditor-General and their reporting to the Auditor-General; and
- the reports of the Auditor-General to Parliament, based on the audit work performed by the agent, Price Waterhouse and any additional work performed by the Auditor-General's office itself.

8.7 This chapter deals with the first part, namely the audit work of Price Waterhouse. The reports of the Auditor-General to Parliament have been dealt with in a separate chapter below. Where appropriate and for the chronological flow of the report, to facilitate easy comprehension, I have included information on the Auditor-General's reporting in this section and cross-referenced it to the chapter on the Auditor-General's reports to Parliament.

8.8 The financial year for SFF ends on 31 March. The financial year ending of 31 March 1993 has been referred to as the financial year 1992/3 as it runs from 1 April 1992 to 31 March 1993. Other financial years have been referred to in similar terms.

ALLEGATIONS

8.9 The resolution of Parliament requests me to *"investigate ... the alleged irregularities with regard to the affairs and financial statements of the SFF Association including ... whether the reports of the Auditor-General thereon were correct and proper"*. These irregularities were defined as those indicated by the Minister and NSN prior to this matter being referred to me, in various responses and statements by the Minister and in the NSN reports. Further evidence given by Mr Petersen from NSN raised various further allegations regarding the audit work performed by Price Waterhouse as the agent of the Auditor-General.

8.10 The allegations raised fell into two broad categories:

- General audit issues – allegations relating to whether overall the audit was appropriate and reasonable.
- Specific audit issues – allegations relating to the auditing of the alleged irregularities ie the Interstate payments, the R1 450 million payment to Government, the Salem recovery and the change in accounting policy.

8.11 Whilst I understand that the overall audit approach will affect the auditing of the specific individual issues, my mandate asks me to look at the Auditor-General's report with regard to the irregularities. As such, I did not feel that my mandate covered looking at every aspect of the audit in general terms. Auditing is a practical topic and therefore findings cannot be made on a theoretical basis. I have therefore addressed the general allegations, but have only made findings in as far as the general allegations relate to the auditing of the specific issues.

8.12 The key allegations raised were:

General audit issues

8.13 The overall standard of the audit with regard to the above matters was not adequate as:

- Price Waterhouse complied only with Generally Accepted Auditing Standards (GAAS) and not with the more onerous Generally Accepted Government Auditing Standards (GAGAS);
- Price Waterhouse relied inappropriately on Internal Audit; and
- Price Waterhouse and the Auditor-General did not act independently of the auditee.

Specific audit issues

8.14 The following specific issues were raised:

- The incorrect disclosure of the Salem monies should have been identified during the audit.
- The cash flow shortage caused by the R1450 million payment on 1 April 1997 should have been identified during the audit.
- The audit opinion on the 1992/3 financial statements was incorrect as the change in accounting policy was not valid and the disclosure was incorrect.
- The audits failed to identify the problems with the Interstate contract.

BACKGROUND TO AUDITING

Types of Auditor

8.15 Before commencing the discussion of the audit, it is important to differentiate between different types of auditors. Specifically in my investigation four types of auditor have been mentioned:

External Auditor

8.16 An external auditor is a Chartered Accountant who performs an independent review of the financial statements in order to render an independent audit opinion thereon. The Auditor-General and his agent Price Waterhouse acted as External Auditors to SFF. All references to "Auditor" in this section, unless specifically differentiated, refer to External Auditor.

Internal Auditor

8.17 Internal Audit reports to Management/the Directors of the company. They are there to assist Management to ensure that the controls in the

business are adequate and operating correctly and therefore the business is being correctly controlled. Internal Audit will assess the risk of the business, review the adequacy of the controls to mitigate the risk and test the controls to ensure their correct operation. SFF had their own internal audit function.

Management Auditor

8.18 This term was used to describe NSN/Mr Petersen. In the context of my investigation the term was used to mean an external accountant appointed by Management to audit specific transactions and report to Management thereon.

Forensic Auditor

8.19 This term was also used to describe NSN/Mr Petersen. The general use of this term today is in reference to an accountant or other person who specialises in investigating fraud through examining various records of the business and other information as required. Mr Petersen specifically stated that he did not have extensive experience as a specialist Forensic Auditor.

The audit opinion

8.20 The format of the reporting of Price Waterhouse and the Auditor-General changed between 1991/2 and 1993/4. During the financial year 1991/2 sanctions against South Africa were still in place. As a consequence of this there were various secrecy requirements with regard to the operation and reporting on the CEF group. The Central Energy Fund Act and the Petroleum Products Act included secrecy provisions with regard to the information that could be published with regard to crude oil transactions. These were slowly relaxed during the financial year 1992/3 and lifted during the financial year 1993/4.

8.21 Price Waterhouse audited the following SFF financial statements:

- 1991/2 and prior periods. Financial statements were prepared for management purposes only and were not published by the Auditor-General, due to the secrecy provisions in place.
- 1992/3. Financial statements were prepared for Management and signed by the Directors and the External Auditors on 2 September 1993. These were later revised to include the change in accounting policy with regard to the transfer of strategic stock and were signed by the Directors and the External Auditors on 7 February 1994. Given the relaxation in the secrecy provisions, the Auditor-General published an abridged version of the management financial statements.
- 1993/4. The secrecy provisions were lifted and the Auditor-General published full financial statements. No separate accounts for management purposes were prepared or audited.

8.22 The secrecy provisions and the Auditor-General's reporting have been discussed more fully in the chapter on the Auditor-General's report to Parliament below.

8.23 The following audit opinions were rendered for each year relevant to this enquiry:

1991/2 audit opinion

8.24 Price Waterhouse rendered the following opinion on the full financial statements prepared for Management:

"Report of the Independent Auditors to the Shareholder of the SFF Association.

We have audited the annual financial statements of the SFF Association set out on pages ... to ... These financial statements are the responsibility of the association's directors. Our responsibility is to express an opinion on these financial statements.

We conducted our audit in accordance with generally accepted auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance that, in all material respects, fair presentation is achieved in the financial statements. An audit includes an evaluation of the appropriateness of the accounting policies, an examination, on a test basis, of evidence supporting amounts and disclosures included in the financial statements, an assessment of the reasonableness of significant estimates and a consideration of the appropriateness of the overall financial statement presentation. We consider that our audit procedures were appropriate in the circumstances to express our opinion presented below.

In our opinion, these financial statements fairly present the financial position of the association at 31 March, 1992 and the results of its operations and cash flow information for the year then ended in conformity with generally accepted accounting practice and in the manner required by the Companies Act, 1973.”

8.25 The Auditor-General did not publish the 1991/2 financial statements. The Auditor-General's reports to Parliament contained the following information in this regard:

“8. Statement of account: (1) owing to the restrictive provisions of section 1E(5) of the Central Energy Fund Act, 1997, the

annual financial statements of the Equalisation Fund and the SFF Association are not published in this Report.”

1992/3 audit opinion

- 8.26 For the financial year 1992/3, it was not initially envisaged that the SFF financial statements would be published. As such Price Waterhouse audited the management financial statements and gave their audit opinion on them, in the same format as for 1991/2.
- 8.27 It was then decided that the Auditor-General would publish an abridged set of financial statements. Price Waterhouse reviewed the abridged financial statements to ensure that they were consistent with the management financial statements and gave their report thereon in a covering letter dated 18 February 1994.
- 8.28 The Auditor-General gave an opinion on those abridged financial statements as follows:

“Report of the Auditor-General to Parliament on the Financial Statements of ... SFF Association ... for the Financial Year ended 31 March 1993....

1. *Audit assignment: The financial statements of ... SFF Association, set out in statements ... and the notes thereto, were audited in terms of section 5 of the Auditor-General Act, 1989 (No 52 of 1989) read with section 1E(3) of the Central Energy Fund Act, 1977 (Act no 38 of 1977) ... These financial statements and the maintenance of the efficient control measures are the responsibility of the Accounting Officer. My responsibility is to report on these financial statements and the matters set out in the aforementioned Acts.*

2. *Regularity audit*

2.1 *Financial*

2.1.1 *Nature and extent: The audit was conducted in accordance with generally accepted government auditing standards which include certain elements of generally accepted auditing standards. These standards require that the audit be planned and performed in such a way as to obtain reasonable assurance that, in all material respects, fair presentation is achieved in the financial statements. An audit includes an evaluation of the appropriateness of the accounting policies, an examination, on a test basis, of evidence supporting the amounts and disclosures included in the financial statement, an assessment of the reasonableness of significant estimates and a consideration of the appropriateness of the overall presentation of the financial statements. I am of the opinion that the audit procedures were appropriate in the circumstances to enable me to express the opinion presented below ...*

2.1.2.2 *Unqualified audit opinions: In my opinion the financial statements of the institutions referred to in paragraph 1 [which included the SFF Association], with the exception of the CEF (Pty) Ltd, fairly present the financial position, at the dates given in the statements, and the results of the operations and cash flow information for the year/period ended on those dates, in accordance with generally accepted accounting practice, and where appropriate, in the manner required by the Companies Act.”*

1993/4 – 1995/6 audit opinion

8.29 In 1993/4 and subsequent years Price Waterhouse have reported to the Auditor-General on the financial statements to be published. The reporting takes the format of a letter. The report relating to the 1993/4 financial statements was in the following format. Years subsequent to this were reported in a similar format:

8.30 Relevant extracts of the letter from Price Waterhouse to the Auditor-General dated 30 September 1994 read as follows (my translation):

“REPORT IN TERMS OF PARAGRAPH 5.4.1 OF AUDIT INSTRUCTION MANUAL PART V(1): General guidelines by Auditor-General for persons conducting auditing on behalf of the Auditor-General, laid down by the Auditor-General on the auditing of Records and Financial Statements of CEF (Pty) Ltd, Equalisation Fund and SFF Association for the year ending 31 March 1994.

We have concluded the audit on the records of above-mentioned institutions for the financial year ending 31 March 1994 and are pleased to report as follows:

“3. Extent of the Audit according to main activities ...”

“2.1 Primary purpose

The primary purpose of the audit is to be able to issue an opinion in terms of section 5 of the Auditor-General Act, No 52 of 1989, on the financial statements of the CEF (Pty) Ltd, Equalisation Fund and SFF Association ...”

“3.1 Reporting and auditing standards

The auditing is carried out in terms of Generally Accepted Auditing Standards, taking the statutory regulations and acts (statutes) which are relevant to the above-mentioned entities.

The investigation carried out is, per definition, a regulatory audit with the emphasis on financial auditing and adherence auditing as prescribed. No performance audit was done. This was the only essential deviation from the generally accepted government auditing standards. Internal control measures are evaluated at the start of the audit with a view to utilise forthcoming results as basis for further auditing.

The regularity of transactions are tested forthwith on a voluntary basis, which tests are not designed as such to expose specific fraud, theft and other malpractices. It has to be pointed out that such malpractices will only be prevented by way of an effective system of internal control and therefore it is the responsibility of the directors and the Management of the group. No system of internal control can wholly prevent collusion between employees.

The test for internal control measurements and the following checking of transactions are being planned and executed on the basis of the following chief activities of the individual entities: ...”

“6.2 Audit Opinion

...Unqualified audit opinions are being issued by our firm about the financial statements for the year ending 31 March 1994 of the SFF Association and the Equalisation Fund. Signed copies of the financial statements are hereby included.”

8.31 The Auditor-General's reports to Parliament contained an unqualified opinion on SFF in the same format as for 1992/3.

1996/7 audit opinion

8.32 No audit opinion has been issued with regard to 1996/7. Whilst the audit has been substantially completed by Price Waterhouse, the Auditor-General is awaiting the outcome of this enquiry before finalising the 1996/7 audit opinion.

8.33 Before I could review the propriety of the audit it was vital to understand the key aspects of the opinions.

Financial statements are the responsibility of the Directors/Accounting Officer

8.34 Sections 1E(1) and (2) of the Central Energy Fund Act 38 of 1977 state the following:

“(1) The chairman of the Board of directors of the CEF (Proprietary) Ltd shall be the accounting officer charged with the responsibility of accounting for all money received by CEF (Proprietary) Ltd or the SFF Association, and for all payments made by CEF (Proprietary) Ltd out of the Central Energy Fund and the Equalisation Fund and other payments made by the CEF (Proprietary) Ltd or the SFF Association.

- (2) *The accounting officer shall –*
- (a) *keep full and true records of all transactions entered into by the CEF (Proprietary) Ltd for the account of the Central Energy Fund or the Equalisation Fund and of all other transactions of CEF and the SFF;*
 - (b) *cause the books and accounts relating to the transactions referred to in paragraph (a) to be balanced as at the thirty-first day of March in each year;*
 - (c) *after the balancing referred to in paragraph (b) prepare, in respect of the Central Energy Fund, the Equalisation Fund, CEF and the SFF, separate statements of income and expenditure for the preceding financial year and balance sheets showing their assets and liabilities as at the end of that financial year.”*

8.35 It is important to note that it is not the responsibility of the auditor to prepare the financial statements. The auditee prepares these.

Fairly present/materiality

8.36 Another key aspect is that the opinions state that the financial statements “fairly present.” Accounting is an art and not a science and therefore, as in many other specialist fields, how a particular item is accounted for or disclosed in the financial statements is subjective. The External Auditor must use his or her expertise to assess if the method of accounting and the disclosure is satisfactory to ensure the financial statements give a fair representation of the financial affairs of the company, based on the relevant accounting statutes and guidelines, so that the information is meaningful for the user of the financial statements.

8.37 The South African Institute of Chartered Accountants (SAICA) Accounting Statement AC000 Framework for the Preparation and Presentation of Financial Statements, states:

“24. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

25. An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

Relevance

26. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

27. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavor to predict the ability of the enterprise to take

advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

28. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.

Materiality

29. The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the enterprise irrespective of the materiality of the results achieved by the new segment in the reporting period. [Note: in this investigation this type of materiality was referred to as qualitative materiality.] In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main

categories that are appropriate to the business. [Note: in this investigation this was referred to as quantitative materiality.]

30. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the enterprise to recognize the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets liabilities and equity of

the enterprise at the reporting date which meet the recognition criteria.

34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognize them in the financial statements. For example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognize items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not

represent faithfully the transaction entered into (if indeed there was a transaction).

Neutrality

36. *To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.*

Prudence

37. *The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognized by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.*

Completeness

38. *To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.*

Comparability

39. *Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.*

40. *An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprise. Compliance with International Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.*

41. *The need for comparability should not be confused with mere uniformity and should not be allowed to become an*

impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

42. *Because users wish to compare the financial position, performance and changes in financial position of an enterprise over time, it is important that the financial statements show corresponding information for the preceding periods.*

Constraints on Relevant and Reliable Information Timeliness

43. *If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.*

Balance between Benefit and Cost

44. *The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it.*

The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For example, the provision of further information to lenders may reduce the borrowing costs of an enterprise. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements should be aware of this constraint.

Balance between Qualitative Characteristics

45. *In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.*

True and Fair View / Fair Presentation

46. *Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an enterprise. Although this framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.”*

8.38 In essence “fairly present” does not mean that the financial statements are 100% accurate, only that the overall picture of the financial position is reasonable and not misleading.

8.39 I noted that for the relevant period 1992/3 to 1995/6 the nett assets of SFF amounted to approximately R2 to R2,5 billion and nett income to approximately R800 to R900 million. Whilst the amounts involved with regard to the alleged irregularities are not insubstantial amounts, they need to be considered against the overall size of the company to understand their significance to the overall operation and reporting of SFF.

Generally Accepted Auditing Standards/Generally Accepted Government Auditing Standards

8.40 The Price Waterhouse audit opinion on the full management financial statements states:

“We conducted our audit in accordance with generally accepted auditing standards.”

8.41 On the other hand the Auditor-General’s report states:

“We conducted our audit in accordance with generally accepted government auditing standards.”

Generally Accepted Auditing Standards

8.42 The scope and methodology of an external audit in South Africa is laid down both in statute, in the Companies Act 61 of 1973, and within various guidelines issued by SAICA. The entirety of these auditing statutes and guidelines makes up GAAS and provide best practice on how an external audit should be performed.

8.43 NSN in their second report highlighted sections 300 and 301 of the Companies Act 61 of 1973 with regard to the duties of an Auditor:

“SECTION 300

Auditors duties as to annual financial statements and other matters.

It shall be the duty of the auditor of a company -

- *to examine the annual financial statements and group annual financial statements to be laid before its annual general meeting;*
- *to satisfy himself that proper accounting records as required by this Act have been kept by the company and that proper returns adequate for the purpose of his audit have been received from branches not visited by him;*
- *to satisfy himself that a register of interest in contracts as required by section 240 has been kept and that the entries therein are in accord with the minutes of directors' meeting;*
- *to examine or satisfy himself to the existence of any securities of the company;*
- *to obtain all the information and explanations which to the best of his knowledge and belief is necessary for the purposes of carrying out his duties;*
- *to satisfy himself that the company's annual financial statements are in agreement with its accounting record and returns;*
- *to examine group annual financial statements himself that they comply with the requirements of this Act;*
- *to examine such of the accounting records of the company and carry out such test in respect of such other auditing procedures as he considers necessary in order to satisfy himself that the annual financial statements or group annual financial*

statements fairly present the financial position of the company or of the company and its subsidiaries and the results of its operations and those of its subsidiaries, in conformity with generally accepted accounting practice applied on a basis consistent with that of the preceding year;

- *to satisfy himself that statements made by the directors in their report do not conflict with a fair interpretation or distort the meaning of the annual financial statements and accompanying notes;*
- *when he gets to know, or has reason to believe, that the company is not carrying on business or is not in operation and has no intention of resuming operation in the foreseeable future, to report forthwith accordingly by certified post to the Registrar;*
- *to comply with any other duty imposed on him by this Act; and*
- *to comply with any applicable requirements of Public Accountants' Act, 1991 (Act No. 80 of 1991)*

SECTION 301

Auditors report

1. *When the auditor of a company has complied with the requirements of, and has satisfied himself as to the matters stated in section 300, and has carried out his audit free from any restrictions whatsoever, he shall make a report to the members of the company to the effect that he has examined the annual financial statements and group annual financial statements and that in his opinion they fairly present the financial position of the company and its subsidiaries and the results of its operations and that of its subsidiaries in the manner required by this Act.*

2. *In the event of the auditor being unable to make such a report or to make it without qualification, he shall include in his report a statement to that effect and set forth the facts or circumstances which prevent him from so making his report or from making it without qualification.*
3. *The auditor's report under subsection (1) shall, unless all the members present agree to contrary, be read out at the annual general meeting."*

8.44 NSN further highlighted the auditing standards as set by SAICA as follows:

"The SAICA issued Guidelines, which set standards according to which auditors perform the attest function, commonly called auditing. These standards known as Generally Accepted Auditing Standards were effective until 31 December 1995 and were superseded effective 1 January 1996 by the South African Auditing standards.

The SAICA have over a number of years been in a process of harmonising South African Auditing Standards with the International Standards. With effect from 1 January 1996, South African Auditing Standards have superseded Generally Accepted Auditing Standards, which now forms part of the South African Auditing Standards. As GAAS still forms part of SAAS and GAAS was applicable for most of the period under investigation, the auditors detailed the requirements of GAAS.

Responsibilities and function of the independent auditor AU001

Objective of the audit

The primary objective of the ordinary examination of financial statements by the auditor is the expression of an opinion on the fairness with which they present the financial position at a given date and the results of operations for the period ended on that date of the undertaking to which they relate.

The auditor's report is the medium through which he expresses his opinion or disclaims an opinion. In either case, his examination should be made in accordance with generally accepted auditing standards.

The auditor should be aware of and comply with any legislation or regulations applicable to the audit appointment. The Public Accountants and Auditors Act, 80 of 1991, deals with the powers and duties of auditors and the Companies Act, 1973 defines the duties of the auditor in reporting on the financial statements of companies. Compliance with auditing standards may, however, require the auditor to extend his audit beyond those matters specifically defined by the legislature.

Distinction between responsibilities of auditor and management

Management has the responsibility for adopting sound account practices, for maintaining an adequate and effective system of accounting records, for the safeguarding of assets and for developing and maintaining a system of internal control that will, among other things, help ensure the production of proper financial statements. The transactions that should be reflected in the

accounting records and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly the fairness of the representations, made through financial statements, is an implicit and integral part of management's responsibility.

The auditor may take suggestions as to the form or content of financial statements or he may draft them in whole or in part based on management's accounting records. However, his responsibility for examination he made is confined to the expression of his opinion on them. The financial statements remain the representation of management.

Responsibility to comply with professional standards

The auditor has a responsibility to comply with generally accepted auditing standards, and he is subject to discipline by the appropriate professional bodies.

Section 26 of the Public Accountants and Auditors Act, deals with powers and duties of auditors, and give Public Accountants' and Auditors' Board the right to inquire into the conduct of a registered accountant and auditor in the performance of his duties.

Professional qualifications

The professional attributes required of the auditor are those of a person with education and experience to practice as such. They do not include those of a person trained to or qualified to engage in another profession or occupation. For example, the auditor, in observing the taking of physical inventory, does not purport to act as an appraiser, a valuer, or an expert in materials. Similarly, although the auditor is informed in a general manner about

matters of commercial law, he does not purport to act in the capacity of a lawyer and may appropriately seek legal opinion in matters of law.

Detection of fraud

When conducting the audit, the auditor should be aware of the possibility that fraud or defalcation may exist. Financial statements may be misstated or defalcations may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management or both. The auditor recognises that fraud if sufficiently material may affect both his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards and he should give consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, including misrepresentations by management, although their discovery may result.

Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The responsibility of the auditor for failure to detect fraud and error should not arise unless clearly resulting from non-compliance with generally accepted auditing standards”.

*Generally Accepted Auditing Standards are categorised as follows in statement **AU010**:*

- *General Standards, and*

- *Standards of fieldwork and*
- *Standards of reporting*

General standards

- *The examination must be performed by or under supervision of a person or persons having adequate technical training and proficiency as an auditor.*
- *In all matters relating to the assignment, an independent mental attitude must be kept.*
- *Due professional care must be exercised during the examination and the preparation of the report.*

Standards of fieldwork

- *The auditor should obtain audit evidence sufficient to enable him to draw conclusions to support the content of his report.*
- *The work is to be adequately planned and audit staff are to be properly supervised.*
- *The auditor should obtain an understanding of the entity's accounting system and related internal controls to assess their adequacy as a basis for the preparation of financial information and to assist in designing his audit procedures. If the auditor intends to place reliance on any internal controls he studies and evaluates those controls.*

Standards of Reporting

- *The report should clearly identify the person to whom it is addressed, the information to which it refers and the purpose for which it is prepared.*
- *The report should convey the scope of examination, whether explicitly or by implication and should state any limitations thereon.*

- *The report shall either contain an expression of opinion, either qualified, or unqualified, regarding the financial information or a clear statement that an opinion cannot be expressed*
- *The elements of 'materiality' and 'audit risk' underlie the application of all standards, particularly the standard of fieldwork and reporting. The concept of materiality is inherent in the work of the auditor. There should be stronger grounds to sustain the auditor's opinion with respect to items which are relatively more important with respect to those in which the possibilities of material error are greater than with respect to those of lesser importance or those in which the possibility of material error is remote.*
- *The degree of risk of error involved also has an important bearing on the nature and extent of the examination. Arms length transactions with outside parties are usually subjected to less detailed scrutiny than inter company transactions or transactions with officers and employees where the same degree of disinterested dealing cannot be assured.*
- *The effect of internal control on the scope of an examination is an outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error, the stronger the internal control, the less the degree of risks.*

Auditing Standards and statements on auditing standards

The generally accepted auditing standards do not deal with the subject matter in detail and where it is considered that members require further guidance on specific matters, statements on auditing standards are issued. These statements are indexed in such a way as to indicate the standard to which they relate and the subject area covered.

A court of law, when considering the adequacy of the work of an auditor, is likely to seek confirmation that in the performance of his work the auditor has in material respects complied with the statements on auditing standards. In the event of significant deviation from the further guidance on specific matters contained in the statements on auditing standards, the auditor may be required to demonstrate that such deviation did not result in failure to achieve the generally accepted auditing standards.”

Generally Accepted Government Auditing Standards

8.45 The Auditor-General's audits are not bound by these general external audit statutes and guidelines, but in practice the Auditor-General complies with them as far as is practicable. The Auditor-General is bound by the Auditor-General Act 52 of 1989 and later 12 of 1995. Sections 3(3) and (4) of the Auditor-General Act 12 of 1995 state:

“ The Auditor-General may at his or her discretion determine the nature and extent of the audit to be carried out and request the details and the statements of account which he or she considers necessary: Provided that he or she may, notwithstanding the provisions of any other law, also determine the format in which and the date on which such details, statements of account and financial statement shall be submitted to him or her.

The Auditor-General shall reasonably satisfy himself or herself that –

- (a) reasonable precautions have been taken to safeguard the proper collection of money to which an audit in terms of this Act relates, and that the laws and instructions relating thereto have been duly observed;*

- (b) *reasonable precautions have been taken in connection with the receipt, custody and issue of, and accounting for property, money, stamps, securities, equipment, stores, trust money, property and other assets;*
- (c) *receipts, payments and other transactions are made in accordance with the applicable laws and instructions and are supported by adequate vouchers; and*
- (d) *satisfactory management measures have been taken to ensure that resources are procured economically and utilised efficiently and effectively.”*

8.46 The provision is in essence the same as that of the Auditor-General Act 52 of 1989.

8.47 The Auditor-General issues guidelines to his agents with regard to the Government audits to be performed for his office. These guidelines are based on International Government Auditing Standards. These Auditor-General Guidelines effectively define Generally Accepted Government Auditing Standards.

8.48 The terms of reference issued by the Auditor-General to Price Waterhouse in respect of the 1992/3 SFF audit referred specifically to the Auditor-General guidelines and as such the audit performed by Price Waterhouse on SFF was in terms of GAGAS.

Generally Accepted Accounting Practice

8.49 SAICA also issues specific accounting statements detailing how various items should be accounted for and/or disclosed. These are referred to as Generally Accepted Accounting Practice (GAAP). The aim of these statements is to ensure that all companies account for and disclose information in a standard way to ensure comparability of information

between companies. However GAAP can go further than these accounting statements. It can also include normal industry practice and international accounting practices if appropriate and not in direct conflict with the South African Accounting Practice.

8.50 The Companies Act 61 of 1973 also sets out certain minimum requirements for the disclosure and format of financial information.

The Companies Act 61 of 1973

8.51 The Companies Act 61 of 1973 specifically legislates on the operation of companies in South Africa. As detailed above, amongst other things the Companies Act legislates on:

- Auditing (chapter X, sections 269-283);
- Accounting and Disclosure (chapter 11, sections 284-313).
- This includes amongst other things the format of the audit report.

Reasonable assurance, plan, perform and testing

8.52 The auditor must carry out his audit to obtain reasonable assurance that his opinion is correct. The auditor is not expected to give 100% assurance.

8.53 The auditing standards give guidance on how an audit should be performed, NSN in their second report highlighted the usual activities in the audit process as detailed in AU015:

“Pre-engagement activities

- *Perform new client investigation, or consider in circumstances of existing client*
- *Determination of skills and competence requirements*

- *Establish terms of engagement*

Planning

- *Obtain, or update, knowledge of the business*
- *Make a preliminary judgement of materiality for planning purposes*
- *Assess inherent risk of misstatement relating to each assertion*
- *Obtain an understanding of the accounting system and related internal controls*
- *Formulate an audit approach*
- *Study those internal controls on which it is intended to place reliance*

Compliance and Substantive Procedures

- *Carry out compliance procedures, where required*
- *Evaluate results of compliance procedures and modify planned substantive procedures, where required*
- *Carry out substantive procedures, where required*
- *Carry out further substantive procedures, if necessary*

Evaluating, concluding and reporting

- *Carry out overall review of the financial information and evaluate the audit evidence*
- *Conclude and formulate audit opinion*
- *Report accordingly.”*

8.54 After the planning of the audit, the detailed audit work is then usually split into two phases, which require further explanation:

Compliance Work

8.55 A company has various controls in place to ensure that everything is accounted for correctly. The auditor can review and test controls he wishes to place reliance on. If the control is adequate he may then rely upon it and limit the substantive work as detailed below. Internal Audit

of a company also review and test controls. The External Auditor rather than reviewing and testing the controls himself may review the internal audit work. If it is reasonable and the results show that the controls are adequate, the External Auditor can rely upon it.

Substantive Work

8.56 The auditor tests the actual financial statements. This testing varies depending on the caption being tested and may be limited depending on how good the controls over the caption are.

Testing

8.57 The auditor does not perform a 100% verification of either the controls or of all the items making up a particular caption in the financial statements. His work is done on a test basis. The auditor will select a sample and test the sample. The sample can be selected on various basis depending on what is being tested.

Acts and regulations applicable to the SFF

8.58 The SFF is a company and as such is governed by the same Acts and regulations as other companies, namely the Companies Act 61 of 1973, as detailed above. In addition as a parastatal organisation, it was governed by the following Acts:

- Central Energy Fund Act 38 of 1977;
- Petroleum Products Act 120 of 1977; and
- Exchequer Act 66 of 1975.

8.59 The audit opinion implies that to the extent that they materially affect the fair presentation of the financial statements all Acts relevant to that company have been complied with.

GENERAL AUDIT ISSUES

Price Waterhouse complied only with Generally Accepted Auditing Standards and not with the more onerous Generally Accepted Government Auditing Standards

8.60 The Auditor-General's guidelines to its agent also detail on how an audit should be performed:

“2.6 Composition of government auditing

2.6.1 Introduction

2.6.1.1 The combination of traditional regularity auditing and performance auditing is referred to as comprehensive auditing and the Office of the Auditor-General has already gained wide support from the public as well as the private sectors for the implementation of this comprehensive approach. A start has already been made with the implementation thereof, and a component conducting performance audits has been established. To elucidate these concepts more clearly, regularity auditing and performance auditing as applied by the Auditor-General, will subsequently be described in more detail.

2.6.2 Regularity auditing

2.6.2.1 *Regularity auditing is divided into the undermentioned two facets which will receive attention simultaneously during this audit :*

(i) Financial accountability

The extent of financial accountability is determined by the measure of control exercised over revenue, expenditure, assets and liabilities. Consequently, this audit will, inter alia, include the examination of the accounting systems as well as appropriation accounts and/or other financial statements such as, for instance, income and expenditure accounts and balance sheets.

(ii) Compliance

The aspect entails compliance with acts, regulations, policy, procedures and other directives and authorisations. The aim of this type of audit is, therefore, to confirm that the public activities were carried out intra vires.

2.6.3 Performance auditing

2.6.3.1 *Traditionally and until recently the audit carried out by the Auditor-General was primarily aimed at regularity aspects as discussed in paragraph 2.6.2 above.*

2.6.3.2 *As a result of limited state revenue sources and an ever-increasing demand for public goods and services, the Auditor-General is obliged to devote evermore attention to the measures instituted by government institutions to ensure that resources are utilised economically, efficiently and effectively so that 'value for money' may be obtained and the stated objectives may in fact be attained. For the*

sake of clarity these concepts are briefly defined as follows:

- (i) Economic utilisation of resources refers to the utilisation of resources of the correct quantities and quality, at the correct time and at the lowest possible cost.
- (ii) Efficient utilisation of resources refers to the relation between inputs and outputs. In this connection two views may be held, namely:
 - maximising of outputs with given inputs
 - minimising of inputs for given outputs
- (i) Effective utilisation of resources refers to the realisation of set objectives.

2.6.3.3 This development is often referred to as value-for-money auditing, operational auditing, management auditing, efficiency auditing and effectiveness auditing. Based on a resolution by an International Congress of Supreme Audit Institutions, the term 'professional auditing' is, however preferred and used by the Office of the Auditor-General."

8.61 There was extensive debate during the leading of evidence of whether Generally Accepted Government Auditing Standards, as detailed in the Auditor-General Acts and his guidelines to his agents are more onerous than Generally Accepted Auditing Standards.

8.62 There were two arguments in this regard:

Investigate, examine and audit

8.63 The Auditor-General Act 52 of 1989 refers to “audit”. However the Central Energy Fund Act 38 of 1977 states that *“the books, accounts, statements and balance sheets ... should be investigated, examined and audited by the Auditor-General”*.

8.64 NSN argued that investigate, examine and audit required more onerous work than just audit.

8.65 The Auditor-General argued that his guidelines were clear with regard to the audit work that was to be performed. He confirmed that investigate and examine was an integral part of auditing. As such I understand that the Auditor-General concedes he has investigated, examined and audited the SFF financial statements and therefore the argument on whether this is more onerous than audit falls away.

Regularity/performance auditing

8.66 It is common cause that regularity auditing as referred to in the Auditor-General’s guidelines (GAGAS) is in effect the same as the normal external auditing as required in GAAS and therefore GAAS is incorporated in GAGAS. Performance auditing is not required under GAAS and is an additional requirement of GAGAS. The performance auditing is directly related to the requirements under the Auditor-General Act 52 of 1989 in section 5(7)(d), quoted below:

“The Auditor-General shall, reasonably satisfy himself that –

(a) ...

(b) ...

(c) ...

(d) *satisfactory management measures have been taken to ensure that resources are procured economically and utilised efficiently and effectively.*”

8.67 It is thus a key component of the Auditor-General Act that he ensures that “*satisfactory management measures have been taken to ensure that resources are procured economically and utilised efficiently and effectively.*” This is stressed further in the Auditor-General’s guidelines as detailed above. As such, as indicated by NSN, it is vital that one of the primary focuses of any Government audit should be whether the control environment is adequate to ensure this.

8.68 Normal regularity audits focus on the fair presentation of the financial statements and do not have as their primary focus whether controls over the economic, efficient and effective use of resources. Although in practice often a review of controls in a regularity audit will identify whether controls in this area are operating correctly. Therefore, I concur with NSN’s conclusion that GAGAS is more onerous than GAAS in that it requires performance auditing and as such specific focus on whether controls are adequate to ensure economic, efficient and effective use of resources.

8.69 Price Waterhouse stated that this matter was discussed with the Auditor-General’s Office in respect of the 1992/3 financial year audit and it was made clear that the audit should be limited to a normal regularity audit, with a report to management highlighting any areas of concern in controls, etc. A performance audit would only be conducted where the management report indicated a significant problem with regard to economy, efficiency or effectiveness. Additional work in this regard would only be performed in agreement with the Office of the Auditor-General.

8.70 Price Waterhouse confirmed that they had audited using GAGAS, as indicated in their letter accompanying the abbreviated financial statements in 1992/3 which stated: “ *Our unqualified audit opinion, which also complies with your requirement, accompanied this set of statements*”, and similarly stated in their reporting to the Auditor-General in the following years. However, they stress that no performance auditing was performed in any of the relevant years, based on the discussions with the Auditor-General and as detailed in their reporting to the Auditor-General with respect to the 1993/4 audit. In this it is stated:

“ The examination conducted is, per definition, a regulatory audit with emphasis on financial auditing and compliance auditing as defined. No performance auditing was carried out. This is the only material deviation from Generally Accepted Government Auditing Standards.”

8.71 However, I do note that performance auditing is a key element of GAGAS. Whilst I have addressed this matter with regard to the specific audit issues below during my investigation I did not pursue this on a more general basis for the reasons stated above. Therefore, whilst I in no way imply that the SFF audit was not adequate in this regard, it was not clear whether in excluding performance auditing with regard to the SFF audit that management controls to ensure economic, efficient, effective use of resources were adequately considered in general terms. It is difficult to understand how the agent can exclude performance auditing, if the Auditor-General is to meet the requirements to ensure that “ *satisfactory management measures have been taken to ensure that resources are procured economically and utilised efficiently and effectively*”. I feel it is vital to stress that detailed performance auditing work could only be excluded if adequate work has been performed to assess that controls in this area are satisfactory.

8.72 It may well be that sufficient emphasis is placed on these controls during a normal regularity audit. However, I feel that if this is the case then this needs to be specifically documented. This would mean that performance auditing was not in fact being excluded, but that if the high level controls assessment indicated that there were no problems with the control environment in this regard that no detailed work would be necessary in this area.

Price Waterhouse and the Auditor-General did not act independently of the auditee

8.73 It is common cause that auditing statutes and standards require that the auditor is independent of the auditee. The Auditor-General's guidelines to his agent further stress the importance of independence. NSN alleged that Price Waterhouse and the Auditor-General did not act independently of the auditee primarily because they passed certain requests for information from NSN to the auditee and back again without appropriately evaluating the information and were guided inappropriately by the auditee.

8.74 It is said that independence is a state of mind. An auditor during an audit will request information from the auditee and discuss that information with them. He must then evaluate that information and come to his own independent conclusions. Lack of independence and objectivity is a serious allegation to raise against any auditor. Therefore there must be incontrovertible evidence that indicates this lack of independence. It is not sufficient to say that an auditor agreed with an auditee and therefore was not independent as he may have applied his mind to the matter to arrive at this agreement.

8.75 With regards to the overall allegation that Price Waterhouse did not act independently, whilst Price Waterhouse corresponded with the auditee, I

have not seen any specific evidence that shows that Price Waterhouse did not appropriately evaluate the information or did not act independently.

SPECIFIC AUDIT ISSUES

8.76 Based on the general auditing and accounting standards and practices as detailed above, a number of specific allegations, as detailed at the beginning of this chapter, have been raised with regard to the sufficiency of the audit in respect of certain of the key issues. These have been dealt with below.

The incorrect disclosure of the Salem monies should have been identified during the audit

8.77 As detailed in NSN's first report the Auditor-General in his letter dated 1 August 1997 advised that as a result of the systems approach used in auditing crude oil sales, the Salem transaction was not subject to any audit tests.

8.78 It has been submitted by the Auditor-General and his agent, and I accept, that the Salem amount of R6 784 754.33 whilst being a significant amount was not material for audit purposes to the 1993/4 SFF annual financial statements and that the misclassification of the receipt did not affect the bottom line profit of SFF. Given this, the fair presentation of the financial statements was not affected by this misclassification.

8.79 It is common cause that the systems approach to auditing referred to by the Auditor-General as detailed in GAAS and GAGAS is an appropriate audit methodology and therefore it is reasonable that the amount was not tested unless there were additional matters that raised the concerns

of Price Waterhouse with regard to this amount. It is common cause that this issue was not raised with the auditors during the audit and that there was nothing to raise their suspicions in regard to this matter to cause them to specifically audit this amount.

- 8.80 Given that the amount was immaterial to the financial statements, did not affect their fair presentation, and that the audit methodology used was reasonable, I find that the audit work with respect to the Salem matter was appropriate.

The cash flow shortage caused by the R1 450 million payment to the Government on 1 April 1997 and the associated strategic stock shortage should have been identified during the audit

- 8.81 The 1996/7 audit was performed on behalf of the Auditor-General jointly by the agents Price Waterhouse and Deloitte and Touche. Price Waterhouse was responsible for 70% of the audit and is the lead firm who will be required to sign off on the audit and report to the Auditor-General. The audit commenced after 1 April 1997 and was completed subject to the Management Audit in June 1997. As such the audit will only be finalised after the completion of my investigation. The draft financial statements for 1997 are not accompanied by an audit opinion.
- 8.82 The strategic stock shortage occurred on 31 March 1997, which is in the 1996/7 financial year. As the audit has not been finalised and no opinion has been rendered, it would not be appropriate for me to comment on the reasonableness or otherwise of this audit.
- 8.83 The payment of the R1 450 million to the Government was actually made in the 1997/8 financial year, which has yet to be audited. However, the Companies Act 61 of 1973, Schedule 4, requires with regard to the Directors' report within the financial statements that:

“(2) The said report shall deal with any material fact or circumstance which has occurred between the accounting date and the date of the report.”

8.84 The financial year-end for SFF is 31 March (this is called the accounting date). However, the financial statements may only be finalised and signed by the Directors and Auditors at some later date (the reporting date).

8.85 The SAICA statements AC105 and AU293 deal with events after the balance sheet date and the audit requirements with regard to those events. AU293 requires that:

“The auditor should perform procedures designed to identify all material events occurring after the balance sheet date and up to the date of his auditor's report which may indicate the need for adjustment to or disclosure in the financial statements.”

8.86 NSN have therefore argued that Price Waterhouse should have identified that the payment of R1 450 million was excessive as part of the 1996/7 audit.

8.87 AU293 also states:

“The procedures to identify events occurring after the balance sheet date should be carried out at or near the date of the auditor's report.”

8.88 As the audit work has yet to be finalised with regard to the 1996/7 audit and no audit opinion has been given it would be inappropriate for me to comment on the correctness of the audit work in this regard. I note, however, that it is reasonable that no post balance sheet work has been

performed as it is required that the work should be performed near the date of the auditor's report, which will only be finalised on completion of my investigation. I also note that Price Waterhouse have taken steps to point out the strategic stock shortage.

The audit opinion on the 1992/3 financial statements was incorrect as the change in accounting policy was not valid and the disclosure was incorrect

8.89 The change in accounting policy relating to the transfer of strategic stock occurred in the 1992/3 financial year. As detailed in the specific chapter on the Change in Accounting Policy, I am of the opinion that the process followed and the expertise utilised in considering the change in accounting policy and its disclosure was reasonable. As such the audit opinion was appropriate in this regard.

Interstate

8.90 A number of allegations have been made with regard to the audit of the Interstate payments:

- Price Waterhouse relied inappropriately on the audit work performed by Internal Audit with regard to crude oil payments.
- The audit should have identified that the payments to Interstate were not made in terms of a valid contract, approved by the Board and were for no value.
- The Auditor-General/Price Waterhouse misrepresented the audit work performed on Interstate to the Minister.

8.91 Price Waterhouse in a letter to the Auditor-General outlined the work performed on Interstate:

“We have been the auditors to SFF for many years and as a result have considerable accumulated audit knowledge of the organisation and its business.

We note in our auditing documentation that we have found management to be highly control conscious and the accounting and controls systems generally to be reliable. We have also found that the internal audit department has in the past continually ensured that the key controls in the accounting system are operating satisfactorily. Our experience showed that the internal auditors testing was such that audit reliance could be placed on their work.

We were also aware that in relation to each oil purchase transaction that this was approved by the Deputy General Manager Crude Oil, the General Manager, and the Chairman of the Board. In the case of margin payments to Interstate, the Crude Oil Management noted that each was in accordance with the agreement. All transactions were checked as a line function by the internal audit department before payment.

The audit approach followed was therefore of a compliance nature supported by analytical review. Typically we performed a walk through test covering each control step for one transaction and then tested specific steps in relation to other transactions. We believe that in the control environment which operated within SFF, our sample selection and approach was appropriate....

The Egyptian contracts and purchase were not regarded as representing a higher risk than others so received no special attention...”

Reliance on Internal Audit

- 8.92 Internal Audit performed detailed work testing the controls with regard to crude oil purchase and sales, both as part of the normal internal audit function and the line internal audit function (these terms have been explained more fully in the Corporate Governance chapter of this report). This work included verifying that payments were made in terms of a valid contract.
- 8.93 Without going into the detail of the arguments presented, in summary NSN have argued that Price Waterhouse had noted serious deficiencies with regard to the work performed by Internal Audit and as such should not have relied upon the work.
- 8.94 Price Waterhouse have responded that the problems noted were mainly to do with the recording and review of the work rather than the actual work itself. In addition they noted that it is common cause that all payments to Interstate were approved at the highest level without exception, so that even if they had not relied on Internal Audit and had tested the controls further themselves they would have relied upon the approvals at the highest level and would not have necessarily tested the contracts.
- 8.95 Significant evidence was heard from Mrs Joubert on the fact that she and her predecessor did not see a valid contract relating to the Interstate payments, but that this deficiency was not noted in any of the Internal Audit reports. Mrs Joubert and Mr Casey testified that at no time had they raised their concerns about the validity of the payments to Interstate with Price Waterhouse or the Auditor-General.

8.96 It is common cause that all purchases of Egyptian crude oil were correctly authorised by the Chairman, General Manager, Deputy General Manager: Crude Oil and Internal Audit.

8.97 As such I find that Price Waterhouse relied appropriately on Internal Audit and the control system in place in formulating the work performed on crude oil payments.

Materiality and value

8.98 It is common cause that the amounts paid to Interstate were quantitatively immaterial to the financial statements for each year. However, NSN argued that given the payment of margins/fees to a non-supplier of oil (Interstate) was unique in SFF, the payments should have received additional attention by the auditors as it was qualitatively material and Price Waterhouse should have identified that the Interstate payments had no value and were not in terms of a valid contract

8.99 With respect to a normal audit, I would concur with Price Waterhouse's representations that it is not the auditor's responsibility to review the commercial viability of a contract, unless this impacts going concern or fair presentation of the financial statements.

8.100 However, the Auditor-General Act 12 of 1995 (which is materially the same as the 1989 Act) specifically states in section 4(d), that the Auditor-General must :

“satisfy himself that satisfactory management measures have been taken to ensure that resources are procured economically and utilised efficiently and effectively.”

8.101 This means that the auditor must review and test the controls (or that work is performed by Internal Audit on those controls), but does not

mean that they actually have to check that the resources have been procured economically and utilised efficiently.

8.102 This is further reiterated in the Auditor-General's guidelines to its agents which requires not only regularity auditing, but also performance auditing. These have been discussed in detail above. However as noted above performance auditing was not included within the scope of the Price Waterhouse audit and as such they had no obligation to perform procedures to check that the resource have been procured economically and utilised efficiently, unless matters were brought to their attention that warranted performance auditing in this regard.

8.103 Even if performance auditing had been required, Price Waterhouse noted that the approval of these payments at the highest level would have been sufficient for external audit purposes to indicate that the controls were reasonable to ensure that the resources were procured economically. I am in agreement with this view.

Misrepresentation of audit sample to the Minister

8.104 NSN further alleged in their first report that the Auditor-General/Price Waterhouse misrepresented the work performed with regard to Interstate in their correspondence with the Minister. In evidence Mr Petersen indicated that a possible reason for this alleged misrepresentation was that the Six Cents Agreement with Interstate contract was only raised at a Board meeting in June 1994 and that therefore the auditors did not want to detail that they had tested matters to do with Interstate prior to this period, as they would have had to identify that the contract did not have Board approval.

8.105 On 14 April 1997, NSN addressed a letter to the Auditor-General, in which the following question was asked:

“Was the payment of 6 US Cents per barrel subjected to any audit procedures during the audit in respect of the financial years 1993 to 1996 and if so, please provide details of the audit procedure and conclusions.”

8.106 In a letter dated 14 April 1997 from Price Waterhouse to the Auditor-General, Price Waterhouse included a schedule which set out the audit selection of crude oil shipments in respect of 1993 to 1996. The schedule split the purposes for which the audit selection of crude oil shipments had been made. The Auditor-General in response to the letter of 14 April 1997, informed Minister Maduna in a letter dated 21 April 1997 that the Barry and Legra IX shipments were included in the audit sample in 1995 and 1996 respectively.

8.107 However, the letter from Price Waterhouse to the Auditor-General included the following additional Egyptian oil shipments as part of the audit sample:

- Panda 1992/3
- Patriot 1993/4
- Langer 1994/5
- Legra 1 1994/5
- Mule 1995/6.

8.108 The Auditor-General stated that the above shipments, whilst they were tested, were not tested for the purpose of auditing crude oil purchases and sales, but were selected for other audit tests and as such did not involve the testing of payments to Interstate. The Auditor-General further noted that Price Waterhouse’s letters with regard to this matter were passed to Mr Petersen and the Minister and as such there was no intention to hide anything.

8.109 From the above there appears to have been a misunderstanding between NSN and the Auditor-General/Price Waterhouse with regard to the audit sample selection. As such I find that there was no misrepresentation by the Auditor-General in this regard.

Fraud reporting

8.110 NSN indicated that there was a duty in terms of the Auditor-General's guidelines to report fraud and therefore Price Waterhouse having failed to identify the fraud relating to Interstate had not reported all fraud.

8.111 Fraud can be defined as unlawfully making, with the intent to defraud, a misrepresentation which causes actual prejudice or which is potentially prejudicial to another (Burchell & Milton Principles of Criminal Law 1st ed 1991 p 523).

8.112 This investigation has not determined that the payments to Interstate were fraudulent – see the chapter on the Purchase of Egyptian Crude Oil and the Related Payments to Interstate.

8.113 In any case, the requirement is to report all fraud. This indicates to me that any fraud, regardless of size should be reported if identified during the normal audit process. An audit is only designed to obtain reasonable assurance that the financial statements fairly present. Given this, fraud may not be identified. As such it makes sense that only fraud that is identified is reported, not that the requirement to report all fraud should mean that all fraud be identified.

8.114 NSN further argued that in order to ensure that the audit did identify as far as possible irregular receipts and payments, the materiality threshold should have been set lower than it was. The main thrust of performance auditing is to check that management has controls in place

to ensure the

economic, efficient and effective use of resources. As such the auditor will test these controls and will not substantively test transactions. When testing controls materiality is irrelevant. The control has either operated or not operated; the size of the transaction where it operated or did not operate, is irrelevant. As such reducing the materiality level would not have assisted in identifying these issues.

8.115 Particularly with regard to Interstate, the amounts paid were very small in relation to the overall size of SFF business. Even if there had been some irregularity with regard to Interstate, the materiality level would have to have been so low to have identified this matter (assuming that due to testing methods adopted by auditors, it had not been excluded from testing) it would have made the SFF audit very time consuming and costly compared to the benefit derived in reducing the materiality levels.

8.116 An examination of the evidence with regard to the audit by Price Waterhouse establishes the following:

- The payments to Interstate were immaterial in the context of the audit.
- The controls over the crude oil payments were at the highest level and operated effectively over the period concerned. As such it was reasonable for Price Waterhouse to rely upon those controls.
- No information was provided to Price Waterhouse that would raise their suspicions with regard to these payments and require them to do additional audit work thereon.

8.117 Based on the above, I conclude that the audit work performed with regard to the Interstate payments was reasonable.

Overall finding

8.118 I am of the opinion that the audit work performed by Price Waterhouse in regard to the matters raised above was satisfactory.